

QUARTERLY REPORT



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

November 15, 2005

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended September 30, 2005. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,628 active members and 4,665 retirees participating in the ERS as of June 30, 2005.

Performance Results

The total return achieved by the ERS assets for the quarter was 4.01%, slightly better than the return of 3.84% of the policy benchmark. For the one year period ending September 30, the ERS' gross return (before fees) was 14.51%, 107 bps. ahead of the 13.44% return of the policy benchmark. The strong one-year return places the ERS' performance in the top 26% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our performance was 15.72%, after fees, ranking in the top 10% of the universe. The asset allocation at September 30, 2005 was: Domestic Equities 48.8%, International Equities 16.3%, Fixed Income 23.7%, Inflation Linked Bonds 9.8%, Alternative Investments 1.1% and Cash 0.3%.

Major Initiatives

The Board selected a new international investment manager, Gryphon International, who will invest approximately 4.5% of the System's assets in international developed markets and up to 0.5% in emerging markets.

During the quarter, the Board conducted a strategic planning meeting, involving all thirteen Board members, to establish the Board's 2006 workplan and discuss public pension fund best practices as identified by a national consulting firm. The Board's 2006 strategic plan includes the development of a risk budget, identification of additional sources of diversification and return to increase the performance of the investment program, the addition of new asset classes and positioning the ERS for the future.

QUARTERLY REPORT

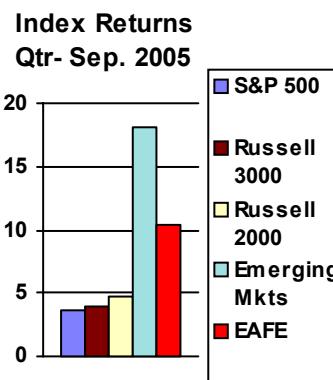
Capital Markets and Economic Conditions

During the early portion of the quarter, economic reports signaled that the U.S. economy remained healthy (lowest unemployment rate since 2001, 9th straight 3%+ increase in GDP, strong retail sales, etc.). At the Federal Reserve's August 9 meeting, interest rates were increased as expected to a rate of 3.5% as the Fed was concerned over the possibility of rising energy prices flowing through to core inflation. Hurricane damage to the Gulf Coast region disrupted supplies of much of the energy used by Americans, which caused a large spike in prices of natural gas (+99%), gasoline (+36%) and crude oil (+17%). On September 20, the Federal Reserve raised interest rates by an additional 25 basis points to 3.75%, and in a move that surprised some investors, the Fed maintained their "measured pace" wording while reiterating their concerns of potentially higher inflation. The dollar was helped by increased interest rates during the quarter, rising 0.7% against the Euro and 2.3% against the Yen.

As shown in the chart to the right, the U.S. equity markets moved higher during the quarter with the broad indices, such as the Russell 3000, up around 4%. Stocks were supported by the expectation of accelerating earnings growth during the quarter, however, U.S. stocks underperformed all other major developed countries in response to worries late in the quarter over higher inflation and the rebuilding of the Gulf Coast region. The best performing sectors in the Russell 3000 were energy, higher by 20.5%, utilities up 7% and technology (+6.3). Equities within the telecommunication sector posted the weakest results, with a loss of 2.5%, while consumer discretionary stocks, led by sharp declines in automakers Ford and General Motors, declined 1.7%. Our combined domestic equity performance was a gain of 4.3% for the quarter, beating the 4.0% return recorded by the Russell 3000 benchmark index. For the one-year period ending September 30, our combined performance is 16.2%, over 160 basis points ahead of the benchmark index.

Within developed markets, Japanese stocks outperformed after the country's Prime Minister Koizumi dissolved parliament and called for special elections. European markets were higher with the best performing markets included, Sweden (+10%), Germany (+9%) and France (+8%). Emerging markets posted the strongest performance for the quarter, up 18.1% in U.S. dollar terms. Performance in emerging markets was higher due to 20%+ returns for oil, steel and chemical companies in Russia, Brazil, Argentina, Poland, Peru, Czech Republic and Hungary. Our combined international equity performance was a gain of 11.63% for the quarter, slightly lower than the benchmark index return of 11.83%.

The yield curve flattened further during the quarter with the difference between the two-year and 10-year Treasury yields moving from 28 basis points to 16 basis points by quarter end. Below investment grade bonds, bonds rated B and CCC, returned the best performance for the quarter. The yield on the 10-year Treasury backed up by 41 basis points to a level of 4.33% during the quarter due to fears of higher inflation, increased expectations of further Fed tightening and the potential high costs of the Gulf Coast cleanup. Our combined fixed income return for the quarter was a loss of 0.29% compared to the 0.21% recorded by the benchmark index. ERS investments in Inflation-Linked Bonds recorded a gain of 1.38% for the quarter.



QUARTERLY REPORT

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending September 30, 2005 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	<u>Qtr 9/30/05</u>	<u>Fiscal YTD</u>
Employer Contributions	\$ 22.1	\$ 22.1
Member Contributions	4.3	4.3
Net Investment Income	<u>82.9</u>	<u>82.9</u>
	<u>\$ 109.3</u>	<u>\$109.3</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System Deductions by Type (millions)

	<u>QTR 9/30/05</u>	<u>Fiscal YTD</u>
Benefits	\$ 30.7	\$ 30.7
Refunds	.2	.2
Administrative Expenses	.4	0.4
	<u>\$ 30.3</u>	<u>\$ 30.3</u>

Outlook

With potential inflationary pressures building, and concerns over a bubble in both the energy and housing markets, analysts anticipate that the Federal Reserve will increase interest rates by 25 basis points at the December meeting to a target level of 4.25%. In the third quarter, mortgage rates for both fixed and adjustable-rate mortgages, increased by 40 basis points, causing further concern for the future of the housing market. In the past few years, the U.S. consumer has been very resilient, continuing to identify income sources other than a paycheck to support their spending habits. Economic growth in 2006 will depend greatly on whether the U.S. consumer can continue to spend.

QUARTERLY REPORT

EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

September 30, 2005

Assets

Equity in County's pooled cash and investments	\$ <u>316,321</u>
<hr/>	
Investments	
Northern Trust	2,209,909,931
Aetna	10,476,508
Fidelity - Elected Officials Plan	<u>750,789</u>
Total investments	<u>2,221,137,228</u>
Contributions receivable	<u>4,150,680</u>
Total assets	<u>2,225,604,229</u>

Liabilities

Benefits payable and other liabilities	<u>2,800,069</u>
Net assets held in trust for pension benefits	<u>\$ 2,222,804,160</u>

QUARTERLY REPORT

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**
September 30, 2005

Additions	Quarter	Fiscal YTD
Contributions		
Employer	\$22,100,409	\$22,100,409
Members	<u>4,284.827</u>	<u>4,284.827</u>
Total contributions	<u>26,385,236</u>	<u>26,385,236</u>
Investment income	84,731,116	84,731,116
Less investment expenses	<u>1,803,638</u>	<u>1,803,638</u>
Net investment income	<u>82,927,478</u>	<u>82,927,478</u>
Total additions	<u>109,312,714</u>	<u>109,312,714</u>
Deductions		
Retiree benefits	28,333,772	28,333,772
Disability benefits	2,065,565	2,065,565
Survivor benefits	257,767	257,767
Refunds	165,138	165,138
Administrative expenses	<u>465,515</u>	<u>465,515</u>
Total deductions	<u>31,287,757</u>	<u>31,287,757</u>
Net increase	<u>78,024,957</u>	<u>78,024,957</u>
Net assets held in trust for pension benefits		
Beginning of period	<u>2,144,779,203</u>	<u>2,144,779,203</u>
End of period	<u>\$2,222,804,160</u>	<u>\$2,222,804,160</u>